

Message Text

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SUBJECT: PROJECTIONS FOR 1976-1977 HONG KONG BUDGET

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SUMMARY: HONG KONG'S BUDGET IS CURRENTLY REGISTERING A SIGNIFICANT DEFICIT FOR THE SECOND CONSECUTIVE TIME. THIS RAISES A NUMBER OF QUESTIONS REGARDING THE GOVERNMENT'S FUTURE APPROACH TO BUDGETARY POLICY.

BASED ON PROJECTIONS FOUND IN FINANCIAL SECRETARY PHILIP HADDON-CAVE'S SPEECHES, SPECULATION ON THE SUBJECT OF TAX INCREASES HAS ARisen IN FINANCIAL CIRCLES. HADDON-CAVE IS HONG KONG'S KEY ECONOMIC DECISION MAKER, AND HIS REMARKS REFLECT PROBABLE TRENDS IN BUDGETARY POLICY. IT IS LIKELY THAT MORE TAX INCREASES WILL BE INTRODUCED IN THE 1976-77 BUDGET SPEECH. END SUMMARY.

1. BACKGROUND: HONG KONG HAS TRADITIONALLY ADHERED TO A POLICY OF LAISSEZ-FAIRE, AND WITHIN THIS TRADITION, GOVERNMENT SPENDING HAS ACCOUNTED FOR A RELATIVELY SMALL PERCENTAGE (18 PERCENT) OF GROSS DOMESTIC PRODUCT. WITH MINOR EXCEPTIONS, IN ALL YEARS UNTIL 1974-75 CURRENT REVENUE HAD

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Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006

COVERED BOTH CURRENT AND CAPITAL EXPENDITURES. OVER THE YEARS, THE HKG HAS ACCUMULATED BUDGETARY SURPLUSES WHICH IT CALLS "THE FISCAL RESERVES." THEY ARE INVESTED IN SECURITIES IN THE U.K. (40 PERCENT), THE U.S. (40 PERCENT) AND ELSEWHERE. THEY YIELD APPROXIMATELY \$60 MILLION PER YEAR IN INCOME TO THE HKG. (ALL FIGURES IN THIS MESSAGE ARE IN U.S. \$)

RECENTLY, HOWEVER, THE SURPLUSES HAVE BEEN REPLACED BY DEFICITS. REVENUES DEPEND UPON THE STATE OF THE HONG KONG ECONOMY, WHICH IN TURN IS DICTATED BY THE LEVEL OF WORLD TRADE. THUS, THEY ARE SUBJECT TO WIDE FLUCTUATIONS, AND HAVE NOT GROWN AT AN EVEN RATE. HKG EXPENDITURES ON THE OTHER HAND, HAVE TENDED TO INCREASE AT FAIRLY CONSISTENT RATES. CONTINUED FAST POPULATION GROWTH AND DEMANDS FOR INCREASED SOCIAL SERVICES ARE LIKELY TO EXERT FURTHER UPWARD PRESSURE ON EXPENDITURES.

WHILE HONG KONG'S BUDGET IS NOT AS SOUND AS IN PRIOR YEARS, IT IS STILL VERY PRUDENTLY MANAGED BY WORLD STANDARDS. CURRENT EXPENDITURES AMOUNT TO ONLY 87 PERCENT OF CURRENT REVENUES. THE DEFICIT INCURRED BY THE HKG, THEREFORE, REPRESENTS A DEFICIT ONLY IN THE CAPITAL ACCOUNT.

2. THE 1975-76 BUDGET SPEECH

IN HIS SPEECH LAST FEBRUARY, THE FINANCIAL SECRETARY LAID OUT HIS COURSE OF ACTION DESIGNED TO COMBAT THE DEFICIT. HADDON-CAVE WAS AWARE OF THREE OPTIONS: 1) RAISE TAXES 2) CUT SPENDING 3) PURSUE DEBT FINANCING. RATHER THAN RELY ON ANY ONE OF THESE OPTIONS, HE DECIDED TO USE A COMBINATION OF THE THREE. FURTHER BACKGROUND IS AVAILABLE IN REFTEL.

WHILE AN INCREASE IN TAXATION REPRESENTS A SIGNIFICANT DEPARTURE FROM HONG KONG'S TRADITIONAL ORIENTATION, FINANCING A BUDGETARY DEFICIT IS ALSO A RADICAL CHANGE.

3. FINANCING THE DEFICIT

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THE FINAL DEFICIT FOR 1975-UY APPEARS TO BE CLOSE TO HADDON-CAVE'S PROJECTION OF HK\$68 MILLION. THE FINANCING ARRANGEMENTS FOR THIS DEFICIT INCORPORATED FOREIGN PRIVATE PLACEMENTS AND DOMESTIC BOND ISSUE.

OFFSHORE FINANCING CONSISTED OF APPROXIMATELY \$60 MILLION IN EUROPEAN AND U.K. PRIVATE PLACEMENTS. THE TERM OF THE LOAN IS FIVE YEARS, AND THE RATES ARE 1.25 PERCENT

ABOVE THE LONDON INTER-BANK RATE FOR THE FIRST 3 YEARS,
AND 1.375 PERCENT ABOVE THE REMAINING 2 YEARS.

THE FIRST SIGNIFICANT ENTRANCE INTO THE DOMESTIC BOND
MARKET BY THE HKG OCCURRED ON NOVEMBER 25, 1975. ON THAT
DATE, THE HKG FLOATED A BOND ISSUE FOR \$50 MILLION WITH A
FIVE YEAR MATURITY AND 6.5 PERCENT COUPON. THE ISSUE
PRICE WAS 99 FOR A YIELD TO MATURITY OF 6.85 PERCENT. BIDS
RANGED FROM 98 TO 105, WITH A TOTAL OF \$43.8 MILLION IN
BIDS ABOVE THE ISSUE PRICE. THE GOVERNMENT TENDER VROUGHT
IN AN AVALANCHE OF OVER \$90 MILLION IN BIDS.

NEVERTHELESS, THERE ARE LIMITS TO THE AMOUNT OF DEBT
WHICH HONG KONG CAN ASSUME, ACCORDING TO HADDON-CAVE, AS
NOTED IN REFTEL.

4. THE FINANCIAL SECRETARY'S OCTOBER, 1975 SPEECH

IN A SPEECH ENTITLED THE FUTURE FOR HONG KONG, HADDON-
CAVE DISCUSSED THE NATURE OF HONG KONG'S ECOONY AND ITS
PROBABLE COURSE OVER THE NEXT TEN YEARS.

THROUGHOUT THE SPEECH HADDON-CAVE STRESSED HONG KONG'S
VIRTUAL RESOURSESLESSNESS AND ITS RESULTINGLY HEAVY DEPENDENCE
ON EXTERNAL TRADE.

IN ORDER TO REMAIN SUCCESSFUL TO THE CONTEXT OF
WORLD TRADE, HE SAID, CAPITAL AND LABOR MUST CONTINUE TO
BE MOBILE AND RESPONSIVE TO CHANGE. IT IS HADDON-CAVE'S
FIRM CONVICTION THAT TO DEVOTE AN EVER LARGER PERCENTAGE
OF G.D.P. TO THE GOVERNMENT SECTOR WOULD HINDER HONG KONG'S
ECONOMIC GROWTH. BY DOING SO, RESOURCES WOULD BE USED LESS
PRODUCTIVELY THAN IN THE PRIVATE SECTOR. HE STATED "THIS
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WOULD LOWER THE GROWTH RATE OF THE ECONOMY WHICH COULD,
IN TURN, LEAD TO HIGHER INTERNAL COSTS AND PRICES,
BALANCES OF PAYMENTS DIFFICULTIES AND THUS A SLOWER
GROWTH RATE STILL; AND THIS PROCESS WOULD BEGIN THE SOONER,
THE LOWER THE GROWTH RATE OF THE ECONOMY AT THE TIME."

HADDON-CAVE CONSIDERS IT IMPORTANT THAT THE RATION OF
TOTAL GOVERNMENT EXPENDITURES TO G.D.P. SHOULD BE HELD
CLOSE TO THE HISTORICAL EXPERIENCE OF 18 PERCENT. HE NOTED
THAT A RISE IN THIS RATION TO 20 PERCENT "...
REQUIRE MORE RADICAL CHANGES TO OUR FISCAL SYSTEM..."

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ACTION EA-09

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5. FORECAST FOR 1976-77 BUDGET

ALTHOUGH THE 1976-77 BUDGET SPEECH WILL NOT BE DELIVERED UNTIL FEBRUARY 24, THERE IS SPECULATION IN HONG KONG'S FINANCIAL CIRCLES THAT A NUMBER OF MAJOR CHANGES MAY BE FORTHCOMING.

HISTORICALLY, THE HKG'S REVENUES AS A PERCENTAGE OF G.D.P. WERE SLIGHTLY LOWER THAN HADDON-CAVE'S TARGETED EXPENDITURE TO G.D.P. RATION. THIS, OF COURSE, WOULD LEAD TO PERPETUAL DEFICITS.

ACCORDING TO AN IN-HOUSE REPORT PREPARED BY A MAJOR U.S. BANK HERE, REVENUES HAVE HISTORICALLY AMOUNTED TO APPROXIMATELY 17 PERCENT OF G.D.P. EXPENDITURES ON THE OTHER HAND, ACCORDING TO HADDON-CAVE, SHOULD BE AT LEAST 18 PERCENT AND MIGHT GO AS HIGH AS 20 PERCENT. THE STUDY ASSUMES 18.5 PERCENT AS REALISTIC. GIVEN THESE PROJECTIONS HONG KONG WILL BE FORCED TO FINANCE A DEFICIT OF ABOUT 1.5 PERCENT OF G.D.P. INDEFINITELY.

NUMEROUS MEMBERS OF THE FINANCIAL COMMUNITY, BOTH WITHIN THE GOVERNMENT AND WITHOUT, FEEL THAT CONTINUING DEFICITS

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IN THE HONG KONG BUDGET WILL SERIOUSLY IMPAIR THE HKG ABILITY TO BORROW. THIS IS DUE TO REASONS WHICH HADDON-CAVE HAS NOTED REGARDING THE VQLNERABLE NATURE OF HONG KONG'S ECONOMY. TO INCUR SUBSTANTIAL FIXED CHARGES BACKED BY VOLATILE REVENUES IS REGARDED AS RISKY, AND COULD CONCEIVABLY BOOST THE HKG'S BORROWING COSTS CONSIDERABLY. THE HKG WILL PROBABLY TRY EITHER TO LIMIT THE DEFICITS OR PERHAPS EVEN TO ELIMINATE THEM ALTOGETHER.

GIVEN THAT THE EXPENDITURE TO G.D.P. RATIO IS NOT LIKELY TO DROP BELOW 18.5 PERCENT AND CERTAINLY NOT BELOW 18 PERCENT, THE REVENUE TO G.D.P. RATIO MUST RISE.

1975 HAS ALREADY SEEN MOVES IN THIS DIRECTION WITH THE ELIMINATION OF THE COMMONWEALTH PREFERENCE IN THE FIRST REGISTRATION TAX ON AUTOMOBILES, AND INCREASES IN IMPORT DUTIES ON LIQUOR AND TOBACCO. OTHER INCREASES MAY OCCUR IN ENTERTAINMENT TAXES, AND BETTING TAXES.

ANOTHER STONG POSSIBILITY IS THAT OF A FURTHER CORPORATE PROFITS TAX INCREASE. ACCORDING TO THE 1975-76 BUDGET STATEMENT, THE 10 PERCENT (15 TO 16.5 PERCENT) INCREASE IN PROFITS TAX IN 1975 IS DUE TO BE REPLACED IN THE 1976-77 BUDGET BY 3.5 PERCENT WITHHOLDING TAX ON DIVIDENDS.

(DIVIDENDS ARE NOT NOW SUBJECT TO HONG KONG PERSONAL INCOME TAX.) IT IS ALSO POSSIBLE THAT THE WITHHOLDING TAX WILL BE INSTITUTED WITH AN ADDITIONAL "ONE YEAR" INCREASE IN THE PROFITS TAX RATE TO AN EFFECTIVE RATE OF 18 OR 18.5 PERCENT.

THE RATES OF PERSONAL TAXATION WERE UNTouched BY THE 1975-76 BUDGET AND REMAIN AT 15 PERCENT. THE FINANCIAL SECREATRY MAY CHOOSE TO INCREASE THESE TAXES.

EVEN IF TAXES ARE RAISED, HONG KONG RATES WILL STILL REMAIN THE LOWEST IN ASIA, AND AMONG THE LOWEST IN THE WORLD. BY DOING SO, HONG KONG COULD PRESERVE ITS TRADITION OF FINANCIAL INTEGRITY AND STILL REMAIN HIGHLY ATTRACTIVE FOR FOREIGN INVESTMENT.
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